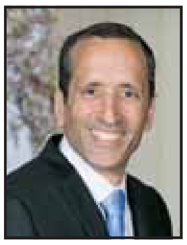
My Best Trade Ever



By Jonathan Caplan

In August I penned an article in this space titled "My Worst Trade Ever." It was intended to be a somewhat tongue-in-cheek description of how to avoid one of the many pitfalls of undisciplined investing. I described my investment in the late 1980s in a then-nascent and little-known computer manufacturer, Dell Computers. From my personal experience with the product, I had come to believe that the company had tremendous growth potential. Yet after a few weeks I had a sudden change of heart. Rather than letting my profits run on the thesis that there was significant price appreciation ahead, I sold the stock, albeit for a profit, but moved on to my next investment. Had I held on for the next decade I would have made a small fortune.

One of the more noteworthy sayings on Wall Street is "Cut losses short, but let your profits run." With regard to my Dell investment, I violated that rule of letting my profits run. But earlier this year I was quite successful in implementing the "cutting losses short" part of the maxim. Implementing that principle can be difficult, mainly because it is an admission of having made an error in judgment. But as you will see, cutting one's losses short can be remarkably beneficial in portfolio performance.

Full Disclosure

I have never been a big fan of momentum investing and have believed for some time that investors (or shall I say speculators) have had an unhealthy fascination with many of the leading stocks in the technology sector. While such prudence and discipline were not rewarded for many years prior to 2022, investors who avoided pricey technology stocks have greatly benefited this year.

As many high-flying technology stocks have cratered this year, our firm's proprietary stock screening process began to show that some of these stocks had fallen enough and were now worth our attention. Specifically, our attention turned to Metaverse Platforms, the stock formerly known as Facebook. CEO Mark Zuckerberg had built a social media powerhouse that helped propel the company's market value to over $1 trillion just about a year ago. But he became concerned about the slowing growth of the company's Facebook and Instagram platforms. Thus, Zuckerberg decided to embark on a massive investment in the "metaverse," which he believed would result in another wildly successful growth platform.

When 'Growth' Morphs Into 'Value'

At the end of last year, the stock of Meta Platforms was trading at $336.35. Based on the company's earnings and cash flow projections for 2022, the stock was trading last year at a large premium to the average stock. At that point our firm had little interest in investing in the company. As the stock market began its descent into bear market territory earlier this year, the stock fell about 40%. From a strict valuation perspective, we were then able to make a case for investing in the company. Indeed, we made a relatively small investment in the stock in February at $217 per share for some of our more growth-oriented accounts. We believed that the core social media business would continue to be a cash-generation juggernaut and that the investment in the metaverse was not an existential threat.

We continued to monitor the news flow from the company and carefully tracked future prospects. Two months later, both my colleague Joseph and I came across an article in our weekend reading that suggested that the fundamentals of Meta Platforms were deteriorating more rapidly than we had projected. In our weekly Monday morning investment committee meeting, we concluded that our investment case for Meta Platforms had some cracks and there could be a meaningful downside. Indeed, we sold the stock at a small loss that Monday morning.

'Whew—That Was a Close One'

Fast forward six months and our reassessment of the risks proved prescient. The stock recently traded below $100 per share as Zuckerberg has doubled down on the metaverse investment and cash flow has been falling rapidly. The stock that we sold at a loss just six months earlier was now down to a price nearly half of what it was when we sold in April. While we do not root for stocks to fall after we sell them, we were gratified that our disciplined investment process indeed paid off.

Winning by Not Losing

You may be wondering why I write stories about "best" trades and "worst" trades. The purpose is not to chronicle war stories and personal experiences investing over many decades. Rather, I hope to highlight valuable tools and strategies that I believe can help improve your experience and financial returns from investing.

I believe that employing disciplined principles in one's investment activities can be rather useful, particularly in a year when both stocks and bonds have been performing poorly. Indeed, this year is somewhat of an outlier in that there have been very few years when both stocks and bonds have generated decidedly negative returns

Most seasoned investors know that bear markets occur with some frequency. But that does not mean that one should give up on the thesis that investments in stocks and bonds can provide investors with healthy long-term returns.

What I hope to impart is that in years like this one, it is especially important to have a disciplined and rigorous process for managing risk in one's investment portfolio. Indeed, I am pleased with how we at Caplan Capital Management, Inc. have been able to navigate this unusually difficult market this year. Our discipline has helped us avoid much of the fallout from the implosion in many parts of the market. When we are wrong, we have no problem admitting our error and are deliberate in reversing course. We are keenly focused on the downside risk of our investments and we believe that has been critical to preserving capital. In bear markets, investors who are disciplined, who focus on "winning by not losing" are likely to be in an advantaged position going into the next bull market.

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